



Department of Energy

Washington, DC 20585

October 24, 2005

MEMORANDUM FOR DISTRIBUTION

FROM:

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CHIEF FINANCIAL OFFICER

SUBJECT:

Interim Guidance for Office of Management and Budget Circular
A-123, *Management's Responsibility for Internal Control*

The purpose of this memorandum is to transmit interim guidance which implements the requirements of Appendix A of the Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control*, dated December 21, 2004. OMB revisited existing internal control requirements for Federal agencies in light of the internal control requirements for publicly traded companies in the Sarbanes-Oxley Act of 2002.

Among the changes to A-123 are requirements for (1) agencies to develop a methodology for management to assess, document, and report on internal controls over financial reporting and (2) an annual assertion by the Secretary on the effectiveness of internal controls over financial reporting to be included in the Performance and Accountability Report. The attached interim guidance describes the methodology Heads of Departmental Elements should use to assess, document, and report on internal controls over financial reporting. Requirements contained in the interim guidance reflect comments received on previous drafts and will ultimately be included in the revised DOE O 413.1A, *Management Control Program*, which is scheduled to be released later in fiscal year (FY) 2006.

The revised Circular became effective in FY 2006 with the annual assurance statement due as of June 30, 2006. Detailed annual guidance will be issued in early FY 2006 and will address the approach for financial statements coverage, types of accounts, and key processes and sites to be reviewed. The annual guidance will provide more prescriptive instructions for accomplishing the assessment and preparing required quarterly and annual reports.

If you have any questions, please feel free to contact me at (202) 586-4171 or have your staff contact John Newell, Director, Office of Internal Review, at (202) 586-9672.

Attachment



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**Department of Energy
Internal Control over Financial Reporting
Interim Guidance**

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Internal Control over Financial Reporting Interim Guidance

1. INTRODUCTION

The private sector has experienced high-profile examples of major companies having weak internal control over financial reporting, which failed to identify financial misstatements. In response to these failures, Congress passed the Sarbanes-Oxley Act of 2002 which required that management of publicly-traded companies strengthen their process for assessing and reporting on internal control over financial reporting. These events have served as an impetus for the Federal government to reevaluate its current policies relating to internal control over financial reporting and management's related responsibilities.

This interim guidance implements the requirements of Appendix A of the Office of Management and Budget Circular A-123, *Management's Responsibility for Internal Control*, (A-123) by formalizing, within the Department of Energy, an approach for assessing, documenting, and reporting on internal control over financial reporting. The approach is to be utilized by Heads of Departmental Headquarters and Field Elements and the Department's major site and facilities management contractors in implementing Appendix A. The reporting by Heads of Departmental Headquarters and Field Elements will be limited in scope to include only internal controls over financial reporting related to programs and operations under their direct control.

DOE O 413.1A, *Management Control Program*, establishes requirements for Heads of Departmental Elements to take systematic and proactive measures to establish cost-effective and appropriate management controls. Inherent in these requirements is the responsibility for Department management to establish strong systems of internal controls over their operations. While the internal control requirements of DOE O 413.1A cover a broad spectrum of processes and activities, this interim guidance focuses specifically on assessing, documenting, and reporting on internal control over financial reporting.

2. SCOPE

Internal control over financial reporting is required for the Department's consolidated financial statements and other significant internal or external financial reports identified by management that could have a material effect on a significant spending, budgetary or other financial decision of the Department or that are used to determine compliance with laws and regulations.

The Department's assessment of internal control over financial reporting will be accomplished in three distinct phases.

- a. Assessing internal control at the entity level. Heads of Departmental Headquarters and Field Elements shall establish site assessment teams with Department and contractor involvement, as appropriate, to perform evaluations of the following five components of internal controls at the entity level: control environment; risk assessment; control activities; information and communications; and monitoring. Detailed information of each component is included under section 4 of this guidance.
- b. Assessing internal control at the process, transaction, or application level. The site assessment teams, established by the Heads of Departmental Headquarters and Field Elements shall perform the following as part of their individual assessments at the process, transaction, or application level: evaluate, based on annual guidance, the major classes of transactions; understand the financial reporting process; gain an understanding of control design; gain an understanding of control design and adequacy; and test controls and assess compliance. Detailed information is included under section 5 of this guidance.
- c. Overall evaluation of the design and operation of internal control over financial reporting. The overall evaluation should conclude whether the Department's internal control over financial reporting is operating effectively or whether material weaknesses exist in the design or operation of those controls. Detailed information is included under section 9 of this guidance.

3. RESPONSIBILITIES

- a. The Secretary of Energy shall develop an assurance statement on the effectiveness of internal control over financial reporting as of June 30th for the fiscal year being reported.
- b. Heads of Departmental Headquarters Elements as determined in the annual identification of material accounts, processes and sites are responsible for:
 - (1) Developing and maintaining effective systems of internal control.
 - (2) Complying with the methodology contained in this guidance for :
 - a. establishing site assessment teams;
 - b. conducting assessments of internal control over financial reporting at their respective sites;
 - c. documenting such assessments;

- d. reporting the results of the assessments, including quarterly status reports and an annual assertion on the financial reporting internal controls under their cognizance; and
- e. implementing and monitoring timely corrective actions.

Material accounts, processes and sites determinations will be included in the annual guidance issued at the start the fiscal year.

- c. Heads of Departmental Field Elements are responsible for:
 - (1) Developing and maintaining effective systems of internal control.
 - (2) Complying with the methodology contained in this guidance for:
 - a. establishing site assessment teams;
 - b. conducting assessments of internal control over financial reporting at their respective sites;
 - c. documenting such assessments;
 - d. reporting the results of the assessments, including quarterly status reports and an annual assertion on the financial reporting internal controls under their cognizance; and
 - e. implementing and monitoring timely corrective actions.
- d. Major Site and Facilities Management Contractors are responsible for developing and maintaining effective systems of internal control. The requirements of OMB Circular A-123 are directed to the Department and not its contractors. However, the Department must institute and maintain effective internal control systems to properly oversee its contractors; and, in light of our special relationship with our major site and facilities management contractors, that oversight must be more intense and focused than that for other contracts. As such, the Department has designed the methodology contained above in 3.b. and 3.c. for assuring it satisfies the internal control obligations in OMB Circular A-123, Appendix A.
- e. The Chief Financial Officer (CFO) has established a Senior Assessment Team with Department and Field CFO participation to oversee efforts to implement the requirements of A-123, Appendix A and recommend to the Departmental Internal Control and Audit Review Council the level of Secretarial assurance the Department should provide on its internal control over financial reporting.
- f. The Senior Assessment Team's responsibilities include the following:
 - (1) Fostering an operational environment to support an on-going awareness of internal controls;
 - (2) Determining those financial reports and major accounts covered by the Department's assessment;

- (3) Ensuring assessment objectives are clearly communicated throughout the Department;
 - (4) Monitoring progress of all assessments being performed;
 - (5) Assessing the adequacy of assertions/reports provided by Heads of Departmental Elements;
 - (6) Recommending to the CFO the Secretarial assertion on the adequacy of internal control over financial reporting; and,
 - (7) Monitoring the progress of implementing corrective actions.
- g. Site Assessment Teams will be established by Heads of Departmental Headquarters and Field Elements with major site and facilities management operating contractor involvement, as appropriate, to perform evaluations of the effectiveness of internal control over financial reporting.
- h. Departmental Internal Control and Audit Review Council (DICARC) shall provide senior management oversight of the Department's internal control program. DICARC reviews and approves findings of the existence of material weaknesses of internal control over financial reporting and determines the Department's material weaknesses and the level of Secretarial assurance the Department should provide on its internal control over financial reporting. Membership includes the CFO (Chairperson); the Inspector General; the Principal Deputy Administrator for NNSA; Assistant Secretary for Environmental Management; a Headquarters Secretarial Officer, appointed on a rotating basis; and a Special Assistant to the Secretary.

4. **ASSESSING INTERNAL CONTROLS AT THE ENTITY LEVEL (Headquarters and Field)**

Assessments of internal controls must include an evaluation of the five components (or standards) of internal controls. These components represent the minimum level of quality acceptable for internal controls and provide the basis against which internal controls are to be evaluated. Heads of Departmental Headquarters and Field Elements shall establish site assessment teams with Department and Contractor involvement, as appropriate, to perform evaluations of the five elements of internal controls at the entity level as follows:

- a. Control Environment. The assessment of internal controls should include obtaining a sufficient knowledge of the control environment to understand management's attitude, awareness, and actions concerning the control environment. The assessment should consider the collective effect on the control environment, since management's strengths and weaknesses can have a pervasive effect on internal controls. Specific elements of the control environment that should be considered include: integrity and ethical standards; commitment to competence; management philosophy

and operating style; organizational structure; assignment of authority and responsibility; and, human resource policies and practices.

- b. **Risk Assessment.** The assessment of internal controls should include obtaining sufficient knowledge of the entity's process on how management considers risks relevant to financial reporting objectives and decides on actions to address those risks. The assessment should determine how management identifies risks, estimates the significance of risks, assesses the existence of risks in the current environment, and relates them to financial reporting. The results of this assessment at the entity level will drive the extent of testing and review performed at the process, transaction, or application level.

Some significant circumstances or events that can affect risk include: complexity or magnitude of programs, operations, transactions, etc; accounting estimates; related party transactions; extent of manual processes or applications; decentralized versus centralized accounting and reporting functions; changes in operating environment; new personnel or significant personnel changes; new or revamped information systems; significant new or changed programs or operations; new technology; and, new or amended laws, regulations, or accounting standards.

- c. **Control Activities.** Control activities are the policies and procedures that help ensure that management directives are carried out and that management's assertions in its financial reporting are valid. The assessment should include obtaining an understanding of the control activities applicable at the entity level, such as: policies and procedures; management objectives (clearly written and communicated throughout the agency); planning and reporting systems; analytical review and analysis; segregation of duties; safeguarding of records; and physical, and access controls.
- d. **Information and Communications.** The assessment should include obtaining an understanding of the information system(s) relevant to financial reporting. Such an understanding should include: the type and sufficiency of reports produced; the manner in which information systems development is managed; disaster recovery; communication of employees' control related duties and responsibilities; and, how incoming external communication is handled.
- e. **Monitoring.** The assessment should include obtaining an understanding of the major types of activities the entity uses to monitor internal control over financial reporting, including the source of the information related to those activities, and how those activities are used to initiate corrective actions. Several examples include: self assessments by management; evaluations by the Office of Inspector General; and, direct testing.

Assessments of internal controls at the entity level may include: mapping internal control assertions to financial statements; mapping key business processes (i.e. determining methods and records used to establish, identify, assemble, analyze, classify and record a payroll transaction); and documenting key processes and related internal controls.

**5. ASSESSING INTERNAL CONTROLS AT THE PROCESS, TRANSACTION, OR APPLICATION LEVEL
(Headquarters and Field)**

The Senior Assessment Team shall annually identify each financial report, significant account or group of accounts, and major classes of transactions to be covered in the assessment based on risk assessments and materiality determinations.

The site assessment teams, established by the Heads of Departmental Headquarters and Field Elements shall perform the following as part of their assessments at the process, transaction, or application level:

- a. Evaluate, Based on Annual Guidance, the Major Accounts and Processes. The assessment should include obtaining an understanding of the specific processes and document flow involved in each class of transactions. Thoroughly understanding the processes and document flow will help in understanding where errors could occur and what control objectives and techniques may prevent or detect those errors.

- b. Understand the Financial Reporting Process. Obtain an understanding of the process and workflow that links the accounting system to the financial report(s). Often times, financial information is not directly transferable from the accounting system to the financial report, but requires intervening calculations, summarizations, etc. This represents another point where errors can be introduced into the financial report, and it is important to understand where such errors could occur and what control objectives and control techniques can prevent or detect the errors.

As information technology evolves, it plays an increasingly important role in the development of internal control over financial reporting. It is critical that technology-based controls are also assessed. Although assessing computer-related controls generally requires specific expertise and procedures not employed in the evaluation of manual controls, the evaluation of computer-related controls should be planned in conjunction with the evaluation of manual internal control over financial reporting.

- c. Gain an Understanding of Control Design. Prepare a control evaluation(s) for each significant account or group of accounts that aligns specific controls with management's assertions for each account or group of

accounts. An individual assessment of the potential effectiveness of the design of the controls for each account or group of accounts should be made considering the risk of error and the controls that are designed and in place to prevent or detect such errors. Assessing the effectiveness of the control design determines whether the control is suitably designed to prevent or detect a material error related to an account or group of accounts.

Procedures to obtain such evidential matter ordinarily include inquiries of appropriate agency personnel; inspection of documents, reports, or electronic files; and, observation of the application of specific controls. This is sometimes referred to as a “walk through” and helps the site assessment team ensure its understanding of the controls. An assessment of the control design should identify controls as effective, moderately effective, or not effective.

- d. Identify Controls Not Adequately Designed. The site assessment teams should test the effectiveness of controls designed by management. If a control over a significant account or group of accounts is missing or its design is determined to be not effective considering the associated risk of error, the site assessment team does not need to test this control for the purpose of concluding on control effectiveness. This instance should be noted in the report of deficiencies and suggestions for improvement. However, management may nevertheless seek to further test affected transactions to determine if there was any actual loss, fraud, error, improper payment, or noncompliance resulting from those ineffective controls.
- e. Test Controls and Assess Compliance. For those controls whose design is deemed effective or moderately effective, the site assessment team should test those controls to determine the extent to which the controls were applied, the consistency of their application, and who applied them. Tests of controls ordinarily include procedures such as inquiries of appropriate agency personnel; inspection of documents, reports, or electronic files, indicating performance of the control; observation of the application of specific control; and re-performance of the application of the control by the site assessment team. If testing indicates that a significant control is not operating as designed, it should be reported as a deficiency.

Assessments of internal controls at the process, transaction or application may include: testing the design of internal controls and key business processes; testing the operating effectiveness of controls and processes; identifying control gaps and internal control deficiencies, reportable conditions or material weaknesses.

6. RELIANCE ON OTHER WORK TO ACCOMPLISH ASSESSMENT

The assessment of internal control over financial reporting should be coordinated with other activities to avoid duplication of efforts with similar activities. For example, Heads of Departmental Headquarters and Field Elements are required to perform reviews of financial systems under Federal Financial Management Improvement Act (FFMIA) of 1996 or information security under Federal Information Security Management Act of 2002 (FISMA). Other reviews performed by management throughout the year that assess the internal control framework should be used to the maximum extent to meet the assessment requirements of Appendix A. Similarly, reviews performed by major site facility management contractors internal audit staffs related to assessment of internal controls conducted in the normal course of their annual risk based audit plan should be used to fulfill Appendix A requirements. Management may consult with the Office of Inspector General (OIG) and the independent auditor when planning and coordinating related work.

The OIG and the independent auditor may be involved in a consulting capacity but shall not conduct management's assessment of internal control over financial reporting. In addition, control weaknesses at servicing organizations, e.g., Defense Finance and Accounting Service, could have a material impact on the controls of the entity being reviewed and, as such, annual assurance statements of servicing organizations should be obtained to allow reliance upon that assertion statement. The Chief Financial Officer will coordinate with all external servicing organizations to obtain the required assurances required for the Department's overall assessment.

7. DOCUMENTATION

- a. Documenting Internal Control over Financial Reporting. The site assessment teams with support from the Senior Assessment Team should document its understanding of the entity's internal control over financial reporting. The form and extent of documentation depends in part on the nature and complexity of the controls; the more extensive and complex the controls, the more extensive the documentation. Documentation may be electronic, hard-copy format, or both and be readily available for examination. Documentation could include organizational charts, flow charts, questionnaires, decision tables, or memoranda. Documentation may already exist as part of normal policy or procedure; however, the site assessment team should separately identify, verify, and maintain the documentation it uses in making its assessment.

Existing documentation prepared by internal or external auditors may also be used, but again, the Senior Assessment Team with support from the site assessment teams must take responsibility and verify and maintain the

documentation. Documentation should also include appropriate representations from officials and personnel responsible for monitoring, improving, and assessing internal controls. After the initial assessment, subsequent assessments may focus on updating existing documentation. All documentation and records shall be properly managed and maintained; therefore, sites will need to establish, or review existing retention policies for documentation (paper and electronic media).

- b. Documenting the Assessment of the Effectiveness of Internal Control over Financial Reporting: The Senior/Site Assessment Teams must also document the assessment process of internal control over financial reporting including:

- (1) Establishing respective teams, their authority and members;
- (2) Identifying contracting actions if contractors are used to perform or assist in the assessment;
- (3) Communicating with site management and employees regarding the assessment;
- (4) Identifying key decisions;
- (5) Assessing methodology and guidance;
- (6) Assessing internal controls at the entity, process, transaction, and application levels;
- (7) Testing controls and related results;
- (8) Identifying deficiencies and suggestions for improvement; and,
- (9) Implementing and monitoring corrective actions.

8. REPORTING

A-123, Appendix A requires the Secretary of Energy to include an annual assurance statement on internal control over financial reporting in the PAR. In support of this requirement and to ensure there is a sound basis for the assurance statement, the following reports are required:

- a. Quarterly Reports. Heads of Departmental Field Elements are required to submit quarterly status reports on their progress in assessing the systems of internal controls in accordance with sections 4 and 5, above. The quarterly reports must identify any deficiencies (either previously reported or newly identified) and corrective actions planned including milestone dates, and actions taken to address the deficiencies. Reportable conditions must clearly be identified in the reports. The Senior Assessment Team will review and evaluate the quarterly reports: (i) to determine whether corrective actions are adequate to address deficiencies; and, (ii) to assess the cumulative impact on the Department's consolidated financial statements. Quarterly reports are essential to ensure that the correct assertion statement is made on the effectiveness of internal control over

financial reporting and to keep management apprised of the current condition of the Department's internal control over financial reporting.

- b. Annual Assertions. Annual assertions on internal control over financial reporting shall be submitted by Heads of Departmental Headquarters and Field Elements. Field or Site Managers at locations where the assessment is performed shall submit documented support for these assertions to their cognizant Headquarters Element with a copy to the CFO. Heads of Departmental Headquarters Elements will consider all supporting information and provide an overall assessment for operations under their cognizance to the CFO. Upon completion of its review of all the Heads of Departmental Headquarters and Field Elements' assertions and related support documentation, the Senior Assessment Team shall provide a recommendation to the CFO on the type of assertion statement that should be included in the PAR.
- c. Identification of Deficiencies. Deficiencies identified in the assessment of the internal controls must be reported in the Heads of Departmental Headquarters and Field Elements Quarterly Reports and their Annual Assertion, as applicable. The Senior Assessment Team shall evaluate these deficiencies to assess the cumulative impact on the Department's consolidated financial statements. In this regard, site assessment teams should report those control deficiencies in the team's assessment that represent significant deficiencies in the design or operation of internal controls that could adversely affect the organization's ability to meet its internal control objectives. For purposes of A-123, Appendix A reporting, these types of deficiencies are called reportable conditions. A reportable condition that the Senior Assessment Team determines to be significant enough to be reported outside of the Department shall be considered a material weakness and should be included in the PAR.

9. OVERALL EVALUATION OF THE DESIGN AND OPERATION OF INTERNAL CONTROL OVER FINANCIAL REPORTING

The Senior Assessment Team shall make an overall evaluation of the design and operation of the internal control over financial reporting based in large part on the quarterly and annual assessments from Heads of Departmental Headquarters and Field Elements. This overall evaluation should conclude whether the Department's internal control over financial reporting is operating effectively or whether material weaknesses exist in the design or operation of those controls.

The Senior Assessment Team will, based on their analysis, recommend to the CFO which reportable conditions, when aggregated, may be deemed material weaknesses to the Department as a whole. The Team will also consider these deficiencies when recommending to the CFO the level of Secretarial assurance

the Department should provide on its internal control over financial reporting. The CFO, along with other senior management members of the DICARC, will make the final determination on which, if any, material weaknesses will be identified for the Department and the level of Secretarial assurance to be included in the PAR.

To ensure accurate assessment and reporting of control effectiveness in the Department's PAR, the Senior Assessment Team will develop a process to identify changes in the internal control environment from June 30th to fiscal year-end, that could potentially impact the effectiveness of internal control over financial reporting.

The Senior Assessment Team will work with the responsible officials and personnel to determine which deficiencies are cost beneficial to correct. Corrective action plans, including targeted milestones and completion dates, will be obtained and progress will be monitored. The Senior Assessment Team may, at its discretion, track findings considered to be less than a reportable condition.

10. REFERENCES

- a. Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control*, Appendix A, *Internal Control Over Financial Reporting*, dated December, 2004.
- b. Implementation Guide for OMB Circular A-123, *Management's Responsibility for Internal Control*, Appendix A, *Internal Control Over Financial Reporting*, dated August, 2005.
- c. General Accounting Office (GAO) *Standards for Internal Control in the Federal Government*, dated November, 1999.
- d. GAO *Internal Control Management and Evaluation Tool*, dated August, 2001.
- e. The Federal Manager's Financial Integrity Act of 1982 (FMFIA) (Pub. L. No. 97-255).
- f. The Chief Financial Officers Act of 1990 (CFO Act) (Pub. L. No. 101-576).
- g. The Federal Financial Management Improvement Act of 1996 (FFMIA) (Pub. L. No. 104-208).
- h. The Federal Information Security Management Act of 2002 (FISMA) (Pub. L. No. 107-347).

Definitions

Control deficiency -- the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A ***design deficiency*** exists when a control necessary to meet the control objective is missing or an existing control is not properly designed, so that even if the control operates as designed the control objective is not always met.
- An ***operation deficiency*** exists when a properly designed control does not operate as designed or when the person performing the control is not qualified or properly skilled to perform the control effectively.

Financial reporting -- includes annual financial statements of an agency as well as other significant internal or external financial reports. Other significant financial reports are defined as any financial reports that could have a material effect on a significant spending, budgetary or other financial decision of the agency or that is used to determine compliance with laws and regulations on the part of the agency. In addition to the annual financial statements, significant reports might include: quarterly financial statements; financial statements at the operating division or program level; budget execution reports; reports used to monitor specific activities such as specific revenues, receivables, or liabilities; and, reports used to monitor compliance with laws and regulations such as the Anti-Deficiency Act.

Internal control over financial reporting -- a process designed to provide reasonable assurance regarding the reliability of financial reporting.

Material weakness (financial reporting)-- a reportable condition, or combination of reportable conditions, that results in more than a remote likelihood that a material misstatement of the financial statements, or other significant financial reports, will not be prevented or detected.

Materiality for financial reporting -- the risk of error of misstatement that could occur in a financial report that would impact management's or users' decisions or conclusions based on such report.

Reliability of financial reporting -- management can reasonably make the following assurances: all reported transactions actually occurred during the reporting period and all assets and liabilities exist as of the reporting date (existence and occurrence); all assets, liabilities, and transactions that should be reported have been included and no unauthorized transactions or balances are included (completeness); all assets are legally owned by the agency and all liabilities are legal obligations of the agency (rights and obligations); all assets and liabilities have been properly valued, and where applicable, all costs have been properly allocated (valuation); the financial report is presented in the proper form and any required disclosures are present (presentation and disclosure); the

transactions are in compliance with applicable laws and regulations (compliance); all assets have been safeguarded against fraud and abuse; and, documentation for internal control, all transactions, and other significant events is readily available for examination.

Reportable condition (financial reporting) -- a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements, or other significant financial reports, that is more than inconsequential will not be prevented or detected.